Mason Stevens OCIO

Managed Fund and ETF Selection 2025

Managed Fund and ETF Selection - Overview

Our manager research capability seeks to identify high quality active managers with strong track records of alpha generation and/or risk mitigation. Our key goal is to gain a high degree of confidence and conviction in a manager's ability to meet their stated objective.

The vast majority of active managers have investment objectives, which if achieved would provide meaningful excess return and/or lower risk when compared to investing passively. The problem however is that the majority of managers do not meet their objectives over time. Historically, this was to a large degree to be expected given fund managers constituted the majority of any given asset class. In such a scenario there will inevitably be a significant percentage of active managers who underperform the market before fees, and an even greater percentage after fees. This point however, has really been highlighted with the huge growth in passive investing, which has offered lower fees and the ability to beat the majority of active managers after fees. With this as context, our focus is ensuring we have a process which more consistently identifies active managers who outperform and/or meet their investment objectives, but also to have the flexibility to consider more passive solutions where we lack conviction in an actively managed solution.

The Mason Stevens process is both repeatable and rigorous and we believe provides greater consistency in isolating and identifying those managers with a far greater likelihood of meeting their objectives over time.

Our managed fund and ETF selection process drives the construction of the Mason Stevens High Conviction List (HCL). The HCL is a concentrated list of managed funds and ETFs across asset classes. The HCL effectively functions as an approved list for advice to our OCIO clients, as well as our Flagship portfolios.

Manager Selection

Selection of Managers will be underpinned by a rigorous due diligence process, designed to identify managers that have a high probability of achieving their stated investment objectives. This process will have three main components:

1. **Quantitative Screen**

Managers within each asset class and sub-asset class are reviewed in terms of performance and ratios within relevant peer groups. An example of how this is done is as follows:

- Breakdown asset classes into smaller peer groups e.g. Australian equities is broken down into large cap value, large cap core, large cap growth, small cap, extension, low-vol etc.
- Consider performance and alpha within peer groups over all timeframes but with a particular focus on 3, 5 and 7 years, which are timeframes that align to managers own stated objectives.
- Look at asset class relevant performance and risk statistics e.g. information ratio, sharpe ratio, tracking error, batting average, active share, turnover, active return and correlation.
- ESG screen – use of Morningstar Sustainalytics to identify any poor performers in this space.
- Cost comparisons – look at total cost ratios in comparison with peers.

This screening process is designed to refine the list of managers under consideration to those where the data is strongly supportive of the manager having a level of investment skill in either alpha generation and/or risk minimisation. Morningstar Direct and Jacobi are the two main systems used for the Quantitative Screen.

2. **External Research House Screen**

Mason Stevens will seek to ensure that most, if not all, managers that are considered have a rating from an external research house. The major external research houses provide broad market coverage, detailed qualitative and operational research. Their output is a ratings methodology that clearly identifies their highly rated managers e.g. recommended and highly recommended. This effectively provides us with an expert second opinion, as well as a cross check against the quantitative screen. Currently we access both Lonsec and Morningstar research ratings.

3. **Direct Manager Research**

Managers that have passed both the quantitative and qualitative screen will then be engaged to complete a due diligence questionnaire (DDQ). This questionnaire is a detailed set of questions that covers key areas of consideration including more objective and data related areas as well as some open-ended questions. We also request key documents such as the Product Disclosure Statement (PDS)/Investment Memorandum (IM) and the Financial Services Council (FSC) Questionnaire. The key areas that are covered as part of the due diligence process includes:

- **Objective and philosophy** – What are they trying to achieve and what is the approach they are taking to achieve that? What is the manager's underlying investment philosophy? What's the evidence that this approach works and why do they think they have an information edge vs peers?
- **Organisation and people** – who is the fund manager, portfolio manager and analysts? How experienced are they? How stable has the team been? How well aligned are the team to the end objective of the fund?

- **Investment process** – is idea generation, security selection, portfolio construction and risk management coherent and does it tie back to the objective? We look for critical thinking and a clear view on what their competitive advantage is.
- **Fees** – are the fees competitive within the peer group and are any performance fees aligned to the interests of investors? Do they inhibit the stated objective?
- **Performance** – assessment of performance against objective and against peers, referencing back to quantitative screen process.

Review of this DDQ will lead to either proceeding with a meeting with the manager or they may be screened out. Mason Stevens will meet with managers by video conference and/or in their office. Manager meetings are held with senior investment personnel. Additional follow-up may be required, where phone, video, email, and further meetings may be requested. Key discussion points from the meeting are documented.

Scoring process

In completing the research process, the manager will then be scored against their peers using the following scale across the five areas of philosophy, people, process, price, and performance. The scoring outcome is defined in Table 1.

Table 1: Mason Stevens Manager Selection Rating Process

Individual Component Ratings	Explanation
0 – 2.0	Poor
2.25 - 2.75	Below average/below peers
3.0 – 3.5	Investment Grade/In line with peers
3.75 - 4.25	Recommended/ahead of peers
4.5 - 5.0	Highly Recommended/significantly ahead of peers
Numerical Scores	**Qualitative Score**
0-2	Sell
2.25 – 2.75	Below average/reduce
3 – 3.5	Investment Grade/Hold
3.75 – 4.25	Recommended/buy
4.5 - 5.0	Highly Recommended/buy

Source: Mason Stevens OCIO

Only managers that score above 3.75 will be considered for the Mason Stevens HCL.

Where a manager is to be put forward for consideration for inclusion, a research note is to be produced for consideration by the Mason Stevens CIO. This will be considered along with the following documents.

- Product Disclosure Statement (PDS) or equivalent.
- Financial Services Council (FSC) Questionnaire or similar RFP due diligence process document.
- Mason Stevens's due diligence questionnaire
- Analyst notes from review meetings, teleconferences, and video conferences.
- Manager presentation material.
- Manager responses to follow-up questions.
- Performance and other quantitative data.

ETF Selection

Selection of ETFs is divided into two approaches. For ETFs that purely track a market cap benchmark, there is a relatively simple yet specific approach, while the approach to rules based, or “Smart Beta” ETFs is effectively the same as outlined above for Manager Selection.

Market Cap tracking ETFs

The aim of these ETFs is to track a market cap benchmark as closely as possible, and as such their ability to track closely to the benchmark is the key consideration when assessing these ETFs. The approach for assessing these ETFs is as follows:

1. **An Initial External Research House Screen**

The major external research houses provide broad market coverage of ETFs, detailed qualitative and operational research. Their output is a ratings methodology that clearly identifies their highly rated managers e.g., Recommended and Highly Recommended. The output is an initial, broad list of ETFs across all asset classes that have undergone detailed due diligence.

2. **Quantitative Screen**

This is an assessment with a primary focus on tracking error and liquidity, which are key in terms of an ETFs ability to track the benchmark index. Primary assessment includes:

- Tracking error e.g., lowest 1 yr. tracking error
- 1-month flows - reflects size and liquidity
- Bid/Ask Spread
- Expense Ratio/Fees
- Fund’s total Assets

These data points provide a clear view on the ETFs track record in tracking an index, as well as the likelihood of its ability to continue to track that index given liquidity and cost considerations. Ranking ETFs across these key tenets provide the list of preferred market cap ETFs to be put forward for consideration for HCL addition. Morningstar is our main tool for reviewing these key aspects of an ETF.

Rules Based (Smart Beta) and Active ETFs

The second approach relates to assessing active and smart beta ETFs. An increasing number of ETFs are either active managers’ portfolios in ETF format, or they are lower cost, smart beta ETFs that follow a specific range of rules in terms of how they are implemented. Examples include high yield/income ETFs, equal weighted ETFs and factor ETFs such as growth and value.

These strategies are all active strategies and as such we apply that same process for manager selection that is detailed earlier in this document. The most important aspect of Smart Beta ETFs are the investment rules of the ETF itself and how they are expected to perform from a risk and return perspective. As an example, high yield Australian equity ETFs have very divergent outcomes given they apply different rules in targeting higher income. Along with Morningstar, we utilise Jacobi to assess rules based ETFs, particular as it relates to adherence to factors.

Assessment and monitoring

There are three main ways in which managers on the HCL are assessed and monitored on an ongoing basis.

1. **Monthly performance assessment**

The review of monthly performance data provides an opportunity to assess the ongoing capability of a manager. Significant short-term deviations from the relevant benchmark and peers may be cause for review. Similarly, a long-term underperformance of the fund's stated objective may also be cause for review. Bottom quartile performance is highlighted and discussed, with consideration of an out of cycle review of these funds as necessary. Factor or style drift is also an area of ongoing review. Morningstar and Jacobi are once again key systems for us in providing the data for review.

2. **Internal sector reviews**

Internal sector reviews across asset classes will be conducted on an ongoing basis, with an asset class fully reviewed every 12-18 months. Where this process results in a change in views on the manager in question, this is presented to the CIO.

3. **External research house review and ratings changes**

External research houses conduct annual reviews across asset classes and update their ratings accordingly. If significant changes emerge between our own internal sector reviews, this may result in an out of cycle review.